Eastern Europe

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## 3. EASTERN EUROPE: BACK DOWN DEBT'S SLIPPERY SLOPE?

East European debt levels rose again after the steady improvement from 1981 to 1984; most countries' ability to service debt is in question. The falling dollar exaggerates the rise in debt, but this also reflects a real decline in trade balances caused by rising imports from the West and declining energy prices. Romania has consistently reduced its debt, but not without pain, and only Czechoslovakia has a debt-service ratio under 20%. Prospects for improvement are dim until well into the next decade.

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Buy dear, sell cheap. Regional trade balances began to fall in 1985; within a year they recorded the first deficit since 1981. Several nations deliberately pursued policies of increasing western imports--manufactured consumables and capital goods intended to modernize their economies. But export earnings took an unexpected drop as falling world energy prices simultaneously cut sales to oil-producing countries and earnings from petrochemical exports.

Snowballing debt. The resulting financial gaps magnified the problem. Poland's debt grew as it missed payments. Others (notably Hungary) had to increase borrowing. The dollar's fall, meanwhile, increased the dollar value of debt borrowed in other currencies. The collective nominal debt burden rose by $12 billion in 1986 and about $10 billion in 1987. Trade balances improved somewhat last year but remain far worse than those of the early 1980s.

Problem children. The most seriously troubled debtors (Poland, Yugoslavia, and Hungary, whose debt-service ratios range from 43 to 74%) are scrambling to prevent further deterioration. All are imposing austerity--including sharp price hikes and economic reforms that may portend future bankruptcies and unemployment. Hungary instituted an income tax, both to try to control the government deficit and to reduce growing private-sector incomes. Poland rescheduled its Paris Club debt in December, Yugoslavia is negotiating a rescheduling package, and Hungary will probably have to do the same by year end.

Obsessive debt repayment. Only Romania has consistently reduced its debt; this year it should reach a net debt of $2.5 billion, the area's smallest. But the Ceausescu regime's obsessive debt reduction has meant cruel austerity and a damaged economy. Now, the policy may be self-defeating, as export production by an eroded economic base begins to fall in both quantity and quality.

Still afloat. Even Eastern Europe's three best credit risks, though still far from significant trouble, were hurt by worsening trade balances. Bulgaria's plunged, and Sofia cut imports sharply early last year. Its debt increased at a rate second only to Hungary's. Starting from a far smaller base, Bulgarian debt still reached only about $6 billion and its debt-service ratio remains relatively low.

East Germany's real gross and net debt also increased significantly. Czechoslovakia's debt-service ratio is the lowest (15%), but all three will see their ability to manage debt constrained if they want to maintain import levels.